Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-218

DEAN D. BEKKEN,

Petitioner,

versus

MERRILL LYNCH, PIERCE,
FENNER & SMITH, INC.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered in the above case on May 15, 1975.

OPINIONS BELOW

The opinion of the District Court for the Northern District of Alabama nor the opinion of the Court of Appeals for the Fifth District was reported. Both are appended together with the District Court's instruction to the jury on the entering of the directed verdict.

JURISDICTION

The judgment of the Court of Appeals for the Fifth Circuit was made and entered on May 15, 1975, a copy of which is appended.

The jurisdiction of this Court is invoked under Title 28, U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Are requirements of New York Stock Exchange Rule 431 pertaining to margins which must be maintained in margin accounts of customers part of a statutory scheme of self-regulation as prescribed by the Securities Exchange Act of 1934?

2. Is a breach of Rule 431 by a broker member of the New York Stock Exchange a bar to a recovery from a customer for a debt unpaid as a proximate consequence of non compliance with Rule 431?

3. May a breach of Rule 431 by a broker under given circumstances give rise to a cause of action in favor of the customer?

4. Was there evidence which if believed would present a jury question on either the complaint by Merrill or the cross-complaint by Bekken.

STATUTES AND REGULATIONS INVOLVED

Pertinent portions of the Securities Exchange Act of 1934, as follows:

Necessity for regulation:

> For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, . . . Section 2, 48 Stat. 881; 15 U.S.C. 78b.

Regulation of national securities exchanges:

> (a) Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions hereinafter provided in this section, by filing a registration statement in such form as the Commission may prescribe, containing the agreements, setting forth the information, and accompanied by the documents, below specified:
>
> (1) An agreement (which shall not be construed as a waiver of any constitutional right or any right to contest the validity of any rule or regulation) to comply, and to enforce so far as is within its powers compliance by its

members, with the provisions of this chapter, and any amendment thereto and any rule or regulation made or to be made thereunder;

(2) Such data as to its organization, rules or procedure, and membership, and such other information as the Commission may by rules and regulations require as being necessary or appropriate in the public interest or for the protection of investors;

(3) Copies of its constitution, articles of incorporation with all amendments thereto, and of its existing bylaws or rules or instruments corresponding thereto, whatever the name, which are hereinafter collectively referred to as the "rules of the exchange"; and

(4) An agreement to furnish to the Commission copies of any amendments to the rules of the exchange forthwith upon their adoption.

(b) No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or discipling of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this chapter or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.

(c) Nothing in this chapter shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with this chapter and the rules and regulations thereunder and the applicable laws of the State in which it is located.

(d) If it appears to the Commissions that the exchange applying for registration is so organized as to be able to comply with the provisions of this chapter and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange. . . . Section 6, 48 Stat. 885, 15 U.S.C. 78f.

Margin requirements:

(a) For the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Board of Governors of the Federal Reserve System shall, prior to October 1, 1934, and from time to time thereafter, prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security). For the initial extension of credit, such rules and regulations shall be based upon the following standard: An amount not greater than whichever is the higher of —

(1) 55 per centum of the current market price of the security, or

(2) 100 per centum of the lowest market price of the security during the preceding thirty-six calendar months, but not more than 75 per centum of the current market price.

Such rules and regulations may make appropriate provision with respect to the carrying of undermargined accounts for limited periods and under specified conditions; the withdrawal of funds or securities; the substitution or additional purchases of securities; the transfer of accounts from one lender to another; special or different margin requirements for delayed deliveries, short sales, arbitrage transactions, and securities to which paragraph (2) of this subsection does not apply; the bases and the methods to be used in calculating loans, and margins and market prices; and similar administrative adjustments and details. For the purposes of paragraph (2) of this subsection, until July 1, 1936, the lowest price at which a security has sold on or after July 1, 1933, shall be considered as the lowest price at which such security has sold during the preceding thirty-six calendar months.

(b) Notwithstanding the provisions of subsection (a) of this section, the Board of Governors of the Federal Reserve System, may, from time to time, with respect to all or specified securities or transactions, or classes of

securities, or classes of transactions, by such rules and regulations (1) prescribe such lower margin requirements for the initial extension or maintenance of credit as it deems necessary or appropriate for the accommodation of commerce and industry, having due regard to the general credit situation of the country, and (2) prescribe such higher requirements for the initial extension or maintenance of credit as it may deem necessary or appropriate to prevent the excessive use of credit to finance transactions in securities.

(c) It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer —

(1) on any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section;

(2) without collateral or on any collateral other than securities, except in accordance with such rules and regulations as the Board of Governors of the Federal Reserve System may prescribe (A) to permit under specified conditions and for a limited period any such member, broker, or dealer to maintain a credit initially extended in conformity with the

rules and regulations of the Board of Governors of the Federal Reserve System, and (B) to permit the extension or maintenance of credit in cases where the extension or maintenance of credit is not for the purpose of purchasing or carrying securities or of evading or circumventing the provisions of paragraph (1) of this subsection . . . .

Section 7, 48 Stat. 886, as amended; 15 U.S.C. 789.

Also, Rule 431 of the Rules of the New York Stock Exchange, Inc. pertaining to the Operation of Member Organizations, in pertinent part as follows:

Margin Requirements.
Rule 431
Maintenance Margin Rule.

(b) The margin which must be maintained in margin accounts of customers . . . shall be as follows:

(1) twenty-five percent of the market value of all securities "long" in the account . . .

(d)

(6) Time Within Which Margin . . . Must Be Obtained: The amount of margin . . . required by any provision of this Rule shall be obtained as promptly as possible and in any event within a reasonable time.

New York Stock Exchange Guide, Constitution and Rules, March 1, 1973.

STATEMENT OF THE CASE

In July of 1971, Dean Bekken opened, with a "loan" agreement, a margin account with Merrill Lynch.

On May 18, 1973, Merrill exercised the authority contained in the "loan" agreement and sold all stock in Bekken's account. There remained an "indebtedness" outstanding, after applying the proceeds, of $16,284.77. On November 13, 1974, a suit based on diversity of citizenship and under the authority of Title 15, U.S.C. 78 aa, was heard before a jury in the United States District Court for the Northern District of Alabama. At the close of evidence, the Court gave a directed verdict for Merrill for the sum claimed, $16,284.77 plus interest from May 18, 1973.

Not in dispute was the following:

Beginning on March 16, 1973, Bekken received printed form notices by mail of outstanding margin maintenance calls on thirty-one of the next forty-five trade days; that Yarbro, Merrill's account executive for Bekken, and Bekken talked daily except for May 16 when Yarbro was out of town on a business cultivation trip; that the securities in Bekken's account in April and May were primarily Kaufman and Broad stocks and warrants; that trading of Kaufman and Broad on the N.Y.S.E. was suspended for one day, May 14, because of adverse publicity; that pertinent circumstances pertaining to the market and the Bekken account, from April 24 through May 18 were as follows:

Date (1973)	Kaufman and Broad Stock Quotation*	Market Value of Securities in Bekken Acct.	Debit Balance	Payments (Cash and Stock)	Bekken s Equity	Margin Maintenance Call Merrill	Margin Maintenance Call NYSE
April							
24	30 3/4	81,727	58,434		23,293	1,224	
25	29 3/4	77,630	58,434		19,196	4,092	212
26	27	68,652	58,434		10,218	10,377	6,945
27	24 1/8	58,530	58,434		96	17,462	14,537
30	24 3/4	54,575	48,396	10,038	6,179	10,193	7,465
May							
1	26	58,100	48,396		9,704	7,725	4,821
2	27 3/8	61,687	48,396		13,291	5,214	2,130
3		63,950		3,675	19,229		
4	27 3/8	59,375	44,721		14,654	3,158	190
7	26	54,862	44,721		10,141	6,316	3,575
8	25 5/8	51,125	42,206	2,514	8,918	6,418	3,863
9	27 5/3	58,162	42,206		15,956	1,492	
10	26 1/8	52,575	42,191		10,383	5,388	2,761
11	26 1/4	53,262	42,191		11,071	4,907	2,245
14	No Trade	53,225	42,191		11,033	4,953	2,273
15	21	37,937	42,191		(4,253)	15,635	13,737
16	18	31,975	41,191	1,000	(9,215)	18,808	17,210
17	15	24,137	41,191		(17,053)	24,4)	23,087
18	15		16,284		(16,284)	16,284	

*Fluctuation of value of warrants in substantially same proportion.

Petitioner believes that Merrill would agree that the following facts are not in dispute:

1. That Bekken had extended previous experience in the market (Bekken testified that he had never previously received a maintenance margin call and his only awareness of an obligation was to do that which Merrill requested).

2. That Bekken asked Merrill to explain the first call he received and how it was calculated; that he was told that there were three ways of meeting maintenance margin calls: (a) cash payments; (b) stock liquidation; and (c) stock appreciation.

3. That Bekken was knowledgeable about Kaufman and Broad stock.

4. That Bekken did not want to sell the Kaufman and Broad stock.

5. That Bekken was not asked to sell the Kaufman and Broad stock during the period in question.

6. That Bekken was not told that there was a time certain in which the margin maintenance calls were to be met.

7. That the only discussion as to what would happen if the calls were not met after so long a time was "then Merrill Lynch has a prerogative to sell in order to meet the call if it continues to decline".

8. That Merrill's policy is that the Account Executive takes precedence over the printed notice in expressing Merrill's position on maintenance calls.

9. That neither Edwards (Office Manager for Merrill) or Yarbro (Account Executive) knew of other situations where securities were not sold prior to the account getting in a deficit position.

10. That Bekken and Merrill knew that either could sell Bekken's securities at any time.

11. That Merrill did not mention that N.Y.S.E. had a margin requirement, nor Rule 431, nor that Merrill's discretion was controlled by a rule of the N.Y.S.E.

12. That Merrill's position on margin maintenance calls is accurately reflected in the following testimony:

That the policy was that each customer was

> "weighed on a different basis. If he was a good customer and he had met previous margin calls by liquidation or depositing money or showed good faith, then certainly that would be considered, but there was no firm rule."

Yarbro was asked if Merrill had the discretion to permit Bekken to remain undermargined:

A For a period of time, yes.
Q How much period of time?
A Well, it varies from customer to customer.

There's no strict rule or was not at that time.
Q It was whatever you deemed was reasonable under the circumstances?
A That's correct.
Q And did you deem, Mr. Yarbro, that it was reasonable under the circumstances not to sell his stock on May 15th following the opening of the market?
A Yes, per his request.
Q At that time there was not enough value in the securities to even pay the indebtedness to you, was there?
A That's correct.
Q And at that time there was a rule of Merrill Lynch as well as the New York Stock Exchange that required upwards of twenty-five percent, twenty-five percent or upwards excess of value over the indebtedness?
A Yes.
Q But you say that it was reasonable in your judgment not to sell on that occasion?
A Well, that's — it varies from customer to customer, and in Dean's case he wanted to keep the stock, hoping for a rebound, and we were not going to try to sell his account out unless we absolutely had to.

Yarbro testified as follows:

Q Did Merrill Lynch instruct you as to what their policy was in terms of requiring customers to respond to maintenance calls.

A No, they leave it to our judgment. The rule is a reasonable time, and we have to exercise that judgment with each customer.

Q From what source were you advised that that was a matter for the account executive's judgment as to what he considered a reasonable time in dealing with any given customer?

A Two sources, the operation manager and the office manager.

Q At what point in time, Mr. Yarbro, would your judgment be subject to being superseded or set aside by the manager of the local office?

A When the margin call was a large percentage of the equity in the account.

Q What does large percentage mean to you?

A Say twenty-five or thirty percent. When it gets in the six to ten thousand dollar category.

Q At that point in time, the office manager has advised that he will make the judgment as to when to sell securities?

A That would be the usual case, yes, sir.

On asking Mr. Yarbro why Merrill did not sell Bekken's securities in the latter part of March, the following occurred:

A . . . We are brokers for the customer and we did not sell it because the customer didn't want it sold and he had been a good customer and we don't sell out accounts unless it's absolutely necessary.

Q All right, sir, would you say that that reason which you have just stated was

controlling on those other occasions in which maintenance calls were made but not satisfied?

A The reason I just gave you because the customer didn't want it sold?

Q Yes.

A Yes, sir.

Q Because the customer did not want it sold and he was a good customer?

A Yes.

Q Now, when you say good customer, Mr. Yarbro, are you talking about from the standpoint of the commission made on sales and purchases?

A Well, that's part of it, the size of the account and promptness to pay and —

Q The meaning that the account has to Merrill Lynch?

A That's correct.

Q And the broker?

A Yes, sir.

Mr. Edwards, Office Manager for Merrill, stated that the policy of Merrill as to when a margin call must be met, was as follows:

A There is not a particular deadline that any client had to meet a maintenance call. It was to be looked at as to the accounts past history, of the desirability of the customer to retain his position, as to the ability of the customer to continue to meet maintenance calls through either market appreciation or liquidation of stock in the account. Each customer was weighed as to

their ability or so they thought would have the ability to meet maintenance calls, and we looked at and tried to appraise each individual account on its own merit.

REASONS FOR GRANTING THE WRIT

1. Certiorari should be granted because this decision of the Court of Appeals for the Fifth Circuit is in direct conflict with its earlier holding in *Gordon v. duPont Glore Forgan, Incorporated, 487 F (2), 260;* Cert. denied June 10, 1974, *94 S. Ct. 3071.*

2. The holding is that Merrill is relieved of the duty to require compliance with maintenance margin requirements of Rule 431 if compliance would be contrary to the customer's wishes. The import of this decision involves much more than the rights here adjudicated. Merrill is invested with the judicially declared license to so apply (or omit to apply) the Rule in its daily dealings.

In view of (a) the frequency of credit not initially undermargined (Regulation T) becoming so (Rule 431) (b) the scope and national import of Merrill's activities (c) the likelihood of Merrill's judicially sanctioned policy becoming a controlling example for its sister brokerage houses (d) the congressional prescription that the national public interest requires the regulation of security transactions (e) and the prescription that the "Board of Governors of the Federal Reserve System shall prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained", it is respectfully submitted that a writ of certiorari should be granted.

3. Certiorari should be granted because of the increasing frequency of decisions in the several Circuits arising out of 15 U.S.C. 78g and the rules and regulations based thereon, together with the pervading importance of protecting against excessive credit in the carrying of securities as well as their purchase.

4. Certiorari should be granted because Bekken, no more and no less important in the eyes of the law than any citizen in the land, has been wrongfully divested of his property and wrongfully ordered to pay a judgment over because of a clear, certain and manifest misapplication of the law.

DISCUSSION OF REASON NUMBERED 1

In granting to Merrill a directed verdict, the trial judge manifestly erred in his application of the holdings of *Gordon v. duPont Glore Forgan, Inc.*, 487 F.2d 1260, and *McCormick v. Esposito*, U.S. Fifth Circuit Court of Appeals, September, 1974, Cause No. 73-1118, 500 F(2) 620.

In *McCormick* the customer sued the broker for damages for violation of Rule 431. ". . . records clearly show that the margin in McCormick's account was below twenty-five percent for each day during the November 18-28 period". "The issue presented to us on this appeal is whether, having established a violation of N.Y.S.E. Rule 431(b) McCormick as a customer of Goodbody has a private cause of action against Goodbody under the Securities Exchange Act of 1934, 15 U.S.C. 78 aa". There was no claim by the broker, Good-

body, against the customer, McCormick. Yet the trial court, in explaining to Bekken jury why it was directing a verdict for Merrill, applied the McCormick court's rational for not giving the customer a judgment against the broker as being controlling in its giving Merrill, the broker, a judgment against Bekken, the customer. The Trial Court further compounded this grievious and manifest error by citing the rational enunciated in *Gordon* as to why the customer was not entitled to relief in his suit against the broker as likewise being controlling in directing a verdict for the broker, Merrill, against the customer, Bekken.

In *Gordon*, the customer, Gordon, sued the broker, duPont, following liquidation by broker, for damages caused by omission to timely notify of the undermargined account, an omission which was inadvertent. Upon discovery the broker immediately asked Gordon to meet the call; negotiations ensued; upon the customer not tendering within a week the monies needed, his securities were sold, leaving a deficit of $1,550.00. The Court found that the account remained undermargined, with the customer's silent knowledge from July 14, 1971, to November 22, 1971; that omission to notify by the broker was inadvertent; that immediate demand, on discovery, was made and the stock sold following a week's unsuccessful negotiations.

The Court held that:

> Gordon's claim for damages was denied because Gordon knew of breach of duty and did not complain; that his conduct constituted acquiescence to the breach; that this constituted in pari delicto defense.

> Broker's claim was denied in that it breached its duty to compute the margin status correctly and give prompt notice of the undermargining; that the deficit was at least partially the result of the broker's breach of duty.

For duPont's breach of duty to notify (it did effect a sale on discovery) the broker was denied recovery (even though the customer had the notice which the broker omitted to give).

Bekken stated throughout that he thought the maintenance call was Merrill's sole prerogative and that he only was obligated to do what Merrill requested; that Yarbro (Merrill's Account Executive) never encouraged him to do more than he did. Yarbro states that he never mentioned a N.Y.S.E. margin call to him; that he never asked him to sell his stock; and the record was replete with his characterization of Bekken as being a good customer. For weighing the propriety of a directed verdict, it is uncontroverted that Bekken was "innocent" in his belief that complying with Yarbro's request was the measure of his obligation. But except for the weighing of Bekken's cross-complaint, we submit that whether Bekken was innocent or not in his reaction to the margin status is immaterial; the question is whether Merrill breached a duty which proximately contributed to the deficit.

As evidenced by the history of this account, set out in the Statement of the Case, the required equity was not maintained. Rule 431 was violated. Notwithstanding, the market actually being closed for trading in the only stock of value in Bekken's account, Merrill did not sell it until four days thereafter — each subsequent

day the account had no margin, Bekken had no equity — only an increasing deficit. Yarbro was schooled on Rule 431 and the securities laws charge the brokers and dealers with knowledge of margin requirements, and the duty to obey them. *Pearlstein v. Scudder & German*, 429 F(2) 1136 (2nd Cir., 1970). Merrill's omission to comply with Rule 431 was willful — however well intended. Compliance is not contingent upon the customer's wishes; if so, the Rule would have no significance — for if the customer wanted it sold, a problem would never arise; if he didn't, under Merrill's contention and the Court's holding, Rule 431 would be a nullity.

And in the *McCormick* case, the Court found the factual situation to be similar to the *Gordon* case. The broker was unaware that the account was in margin; the customer knew it and remained silent. The Court noted that there was no intentional violation by the broker nor was the customer misled. The Court did not permit the customer to recover from the broker — the Court chose not to imply a right of action in the customer's favor. But the case most certainly is not authority for the proposition that notwithstanding the broker's breach of duty, the broker is entitled to recover the deficit from the customer. "We cannot allow duPont to recover indebtedness that resulted from its own breach of duty, and therefore we must reject its counterclaim". (*Gordon v. duPont Glore Forgan, Inc.*, supra)

In the limited significance of this Court's holding, Bekken has been wrongfully deprived of his property; he relied for redress on the Court of Appeals previous pronouncement in *Gordon v. duPont Glore Forgan, Inc.*, supra. In the much broader significance, the issue presented is of a practical, present, and far reaching importance. It is reasonable to conclude that Bekken is one of hundreds of daily instances in which a maintenance margin situation is present. Merrill, much involved in this proceedings, has all the assurance that our judicial system can give that its duty to enforce credit requirements is contingent upon its customer's wishes — unless this Honorable Court grants certiorari.

DISCUSSION OF REASON NUMBERED 2

Congress mandated the Board of Governors of the Federal Reserve System to prescribe rules and regulations with respect to the amount of credit that may be subsequently maintained in carrying securities. 15 U.S.C. 78g(a). In implementing this prescription, the Board of Governors delegated to the Securities and Exchange Commission and the Stock Exchanges the regulation of maintenance margins. Our Courts have consistently held that the Securities Exchange Act imposes a duty upon an Exchange to enforce its rules promulgated and filed with the Securities and Exchange Commission. *Bright v. Philadelphia-Baltimore-Washington Stock Exchange*, 327 F. Supp. 495 (1971, Pa.); *Silver v. New York Stock Exchange*, 373 U.S. 341, 360; 10 L. Ed. (2) 389, 402; and one of these rules is Rule 431. Rule 431, a margin requirement, is in lieu of a commission rule; as such it is an official arm or delegate of governmental power.

Colonial Realty Corporation v. Bache & Company, 385 F(2) 178 (1966). It is the duty of Courts to be alert to provide such remedies as are necessary to make effective the congressional purpose of an act. *J.I. Case Company v. Borak*, 377 U.S. 426, 84 S. Ct. 1555, 12 L. Ed. (2) 423 (1964); *S.E.C. Report of Special Study of Securities Market H. R. Document No. 95*, 88th Congress, First Session (1963). The onus of meeting certain minimum margin percentages are clearly placed on the brokers and dealers, and not on their customers. *Avery v. Merrill Lynch, Pierce, Fenner & Smith*, 328 F. Supp. 677. The *Avery* case involved Regulation T and initial margins but the holding and reasoning is equally applicable to maintenance margin requirements, for the language of 15 U.S.C. 78g makes no distinction between its concern for the two.

The federal securities laws charge brokers and dealers with knowledge of margin requirements and the duty to obey them. *Pearlstein v. Scudder & German*, supra.

The rules of the New York Stock Exchange which Merrill agrees to abide by as a member; the Securities Exchange Act requiring that such rules be filed and approved (and remain unchanged unless a proposed change has the Commission's prior approval); the mandate by Congress that the "national public interest" requires rules to be promulgated respecting the amount of credit that can be initially extended and subsequently maintained — all place a duty, independent of the customer's involvement or wishes, on Merrill to comply with Rule 431. The effect of the trial court's holding as affirmed by the Court of Appeals is that Merrill can sit back, the customer being willing,

and with impunity await the customer's decision. If and when Merrill chooses to convert the securities to money, it is entitled to a judgment against the customer for such deficit as there upon results.

This action may be looked upon as ex contracto based on the contract between the stockholder and the customer as affected by federal statutes and regulations. *Goldenburg v. Bache & Company*, 270 F(2) 675 (5th Cir., 1959). Both the common law duty arising out of the fiduciary relationship, the contractual duty imposed by Merrill's membership in the N.Y.S.E., and that duty imposed by statute setting out the scheme of self-regulation as part of a partnership between the private and public sector contemplated by the Securities Exchange Act, all place the unavoidable duty of complying with Rule 431 on the broker.

Petitioner submits that the import of this decision is of great, immediate and recurring importance. This credit policy as interpreted by the trial court and Court of Appeals to Merrill and applied by Merrill with the approval of these Courts has the potential for tremendous cumulative effect on the incidence of "excessive" credit, and perforce, on the nation's public interest. Merrill has, through the inadvertence of the trial court and the Court of Appeals, been commissioned to use Merrill's words, not to sell out "accounts unless it is absolutely necessary" the yardstick of what is "necessary" being governed not by the presence or absence of the required margin, but by how good a customer the account in question has been.

DISCUSSION OF REASON NUMBERED 3

An examination of Volumes 475 F(2) to date reveals that the margin aspect of Section 7 of the Securities Exchange Act (15 U.S.C. 78g) has been the subject of the following cases:

Spoon v. Walston & Co., 345 F. Supp. 518, 478 F(2) 246 (6th Cir., 1973).

This was an action under Regulation T governing on the authority of 15 U.S.C. 78g initial margins. The District Court stated:

> "The Court will not entertain a cocophony of blame on the part of the brokers and customers — each blaming the other for not meeting the requirements — the ultimate responsibility must be placed somewhere and Congress has indicated that it is with the brokers or dealers. This Court does not intend to change this explicitly expressed legislative judgment by imposing common law causation standards upon the regulations."

Jennings, et. al. v. Boenning & Company, 482 F(2) 1128 (3rd Cir., 1973).

Gordon v. duPont, supra, re maintenance margin.

Grove v. First National Bank of Herminie, 489 F(2) 513, (3rd Cir., 1973) pertains to a suit by customer against Bank under Regulation U promulgated under the authority of Section 7 of the Securities Exchange Act (15 U.S.C. 78g). Bank lent more than permissible.

Court, sitting without a jury, held that a lending bank may not recover a deficiency where it violated margin requirements, and such a recovery may be precluded even if the borrower knowingly and intentionally deceived the Bank as to the actual purpose of the loan. The Court gave a judgment for the customer. *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74 (S.D.N.Y., 1968) aff'd. 409 F(2) 1360 (2nd Cir., 1969); *Goldman v. Bank of Commonwealth*, 467 F(2) 439 (6th Cir., 1972).

Brenner v. Mitchum, Jones and Templeton, Inc., 494 F(2) 881 (9th Cir., 1974) involved a suit under Regulation T and the principle of collateral estoppel.

Freeman v. Marine Midland Bank, 494 F(2) 1334 (2nd Cir., 1974) pertained to a suit under Regulation U.

McCormick v. Esposito, supra.

Daly v. Capitol Bank & Trust Company, 506 F(2) 1375 (1st Cir. 1974) pertained to a suit under Regulation U.

> "The margin provisions of the Exchange Act were enacted primarily to stabilize the securities market by regulating the flow of credit and secondarily to protect margin stock purchasers."

Landry v. Hemphill, Noyer & Co., 473 F(2) 365 (1st Cir., 1973):

> "It is well established that a subsidiary purpose of 78 g of the Securities Exchange Act is to protect the small investor from the danger

of excessive trading on credit. (*Remar v. Clayton Securities Corp.* 81 F. Supp. 1014) (Mass., 1949)

Neflatin v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 499 F(2) 1166 (8th Cir., 1972) pertains to Regulation T and "churning".

The purpose in citing the above was to give convenient insight into the time which has been devoted in the several circuits on questions involving maintenance margins which are the subject of 15 U.S.C. 78g — one of two primary purposes of the Securities Exchange Act. We respectfully submit that a clear expression by this Court is needed on the part that Rule 431, or such other self-regulating margin governing procedure as may be substituted therefor, is to play in controlling credit in the purchase or carrying of securities. Congress has evidenced its concern by enacting the Securities Exchange Act which, by all measurements, has become one of the country's most important pieces of legislation. The amount of litigation involving same is impressive. The holding of the Trial Court and the Court of Appeals in this case has rendered the self-governing aspect of the Act as it pertains to credit which may be subsequently maintained inoperative to accomplish its purpose — that of controlling the amount of credit outstanding.

We respectfully submit that a writ of certiorari should issue.

DISCUSSION OF REASON NUMBERED 4

With all the frustrations of not being able to get our judicial system to prevent a glaring, and certain, wrong, personally tragic in both its financial and psychological impact on this petitioner, and more important in the larger sense, publicly tragic because it is clearly in conflict with and contrary to important and substantial principles of law enunciated by statute and the Courts, which have widespread, present and recurrent application, we respectfully submit that a writ of certiorari should be issued. If the question here raised is not resolved by this Court, the mechanics for making effective maintenance margin requirement will have been emasculated — if it is fair to presume that what's "lawful" for Merrill is likewise for its fellow brokers.

CONCLUSION

The Petition for Certiorari should be granted.

Respectfully submitted,

Roscoe Roberts, Jr.
Counsel for Petitioner
Post Office Box 287
Huntsville, Alabama 35801
(Telephone: Area Code 205
533-3500)

PROOF OF SERVICE

I, Ernest L. Potter, of the firm of Butler & Potter, attorneys for Merrill Lynch, Pierce, Fenner & Smith, Inc. hereby acknowledge receipt of the foregoing Petition for Writ of Certiorari on this ____ day of August, 1975.

Ernest L. Potter
Butler & Potter
Counsel of Record
for Merrill Lynch,
Pierce, Fenner
& Smith
122 South Side Square
Huntsville, Alabama 35801

CERTIFICATE OF SERVICE

I, Roscoe Roberts, Jr., attorney of record for Dean D. Bekken, Petitioner, hereby certify that all parties required to be served have been served a copy of the Petition for Writ of Certiorari.

This ____ day of August, 1975.

Roscoe Roberts, Jr.

APPENDIX A

WEDNESDAY NOVEMBER 13th 1974

JUDGMENT ON DECISION BY THE COURT

UNITED STATES DISTRICT COURT
FOR THE
NORTHERN DISTRICT OF ALABAMA,
NORTHEASTERN DIVISION

MERRILL LYNCH, PIERCE, FENNER
& SMITH, INC., A Corp.

versus No. CA-74-L-542-NE

DEAN D. BEKKEN

JUDGMENT

This action came on for trial on November 12, 1974 before the Court and a jury, Honorable Seybourn H. Lynne, United States District Judge, presiding, and the issues having been duly tried and a decision having been duly rendered, on November 13, 1974

It is Ordered and Adjudged that upon motion for a directed verdict filed by the plaintiff at the close of all evidence be and the same is hereby granted; that the plaintiff Merrill Lynch, Pierce, Fenner & Smith, Inc., a Corp. have and recover of the defendant Dean D. Bekken the sum of $17,734.56; and taxing costs against the defendant Dean D. Bekken.

It is further Ordered by the Court that the defendant pay direct to the attorneys or record for the plaintiff the proceeds of the judgment and costs recovered herein by the plaintiff, and that upon receipt thereof, the attorneys of record for the plaintiff will satisfy said judgment on the record of this court.

William E. Davis,
Clerk
/s/ [ILLEGIBLE]
Deputy Clerk

Court Reporter — John Weaver
Decatur, Alabama
Filed: November 13, 1974
William E. Davis,
Clerk
/s/ [ILLEGIBLE]
Deputy Clerk

APPENDIX B

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 75-1188
Summary Calendar*

MERRILL, LYNCH, PIERCE,
FENNER & SMITH, INC.,
Plaintiff-Appellee,

versus

DEAN D. BEKKEN,
Defendant-Appellant.

Appeal from the United States District Court for the
Northern District of Alabama

(May 15, 1975)

BEFORE GEWIN, GOLDBERG and DYER, Circuit Judges.

PER CURIAM: AFFIRMED. See Local Rule 21.[1]

---

* Rule 18, 5 Cir.; See Isbell Enterprises, Inc. v. Citizens Casualty Co. of New York, et al., 5 Cir. 1970, 431 F.2d 409.

1 See N.L.R.B. v. Amalgamated Clothing Workers of America, 5 Cir., 1970, 430 F.2d 966.

APPENDIX C

Jury Instruction by Trial Court
Coincident with Directed Verdict

THE COURT:

Ladies and gentlemen of the jury, this case was submitted for the judgment of the Court on the motion of plaintiff for summary judgment. At that time my law clerk, Mr. Mabry Rogers, prepared a memorandum dealing with the application of Rule 431 of the New York Stock Exchange to the facts as disclosed on the motion for summary judgment and recommended that there should be a full trial and it should not be disposed of on motion for summary judgment, and with that recommendation I agreed and denied the motion for summary judgment.

It now becomes my duty to determine whether or not there are any fact questions to be submitted to the jury, and I have determined under the law as I understand it that there are no fact questions to be presented on the original claim of the plaintiff or on the counter-claim of the defendant, and as I usually do, I like to try to advise the jury of my thinking in coming to the conclusion that the plaintiff is entitled to a directed verdict for the amount sued for with interest at six percent from May the 18th, 1973, to date.

My reasoning is based upon the cases dealing with that rule decided by the Court of Appeals for the Fifth Circuit by those opinions I am bound. The first of the cases with which I deal is the case of Gordon versus duPont Glore Forgan, Inc., which is reported in 487 Federal Second at page 1260 decided by the Fifth Circuit on December the 10th, 1973. Later on that case was followed by the case of McCormick versus Esposito

which was decided by the Fifth Circuit Court of Appeals on September the 13th, 1974, and I think that by reading you certain statements in that opinion you will follow the reasoning which has led me to direct a verdict in favor of the plaintiff in this case, and I'm going to interpolate certain terms in here after I read it.

McCormick contends that over a substantial period of time Goodbody, which is a brokerage house, violated Rules 431 and 432 of the New York Stock Exchange by the manner in which it maintained McCormick's account. Judge Thornberry, writing for the Court in Gordon, which is the case which I referred which was decided last December, explained the inequity of permitting the customer to recover under such circumstances, and those circumstances were that McCormick received a monthly statement of his account and was aware of the varying equity debit status of his account. He certainly had reason to know when his account was under-margined. As far as the District Court found, Mr. McCormick is a lawyer, has been in and out of the securities marketplace since 1929, personally maintained full control over his account and was at all times completely informed as to the securities position of his account. McCormick did not complain of Goodbody's maintenance margin practices or take any corrective action before Goodbody liquidated his account in February, 1970, and he continued his silence until Goodbody brought its State Court action against him in January, 1971.

Now, in referring to that case, in the Gordon case, the writer of the opinion in McCormick said that Judge Thornberry writing for the Court in Gordon explained the inequity of permitting the customer to recover under such circumstances, and I quote from Judge Thornberry's opinion. "The broker's error allowed Gordon to avoid bothersome margin calls while

his equity dwindled. He could gamble that his stock would appreciate in value without having to bolster his margin account with resources he could employ elsewhere. And when his stock fell so low that his margin account had a deficit instead of equity, he had no incentive at all to put up more margin, for he could simply let the broker sell him out and let duPont take part of the loss."

And in further comment, the Court said, "In the absence of any evidence of a broker's intentional violation of Exchange rules misleading of its customer and in the presence of a customer who knew or should have known that his account was under-margined but took no corrective steps for so long as he stood to benefit from such under-margining, we decline to depart from the rule in Gordon. Finally, while we do not foreclose the use of New York Stock Exchange Rules 431 and 432 as a protective cloak for investors if circumstances warrant, we will not permit their use here by a knowing beneficiary as a dagger against his perhaps too lenient broker."

Now, this Court is bound by that interpretation of Rule 431, and 431 is at the heart of this case under the defendant's defense and his counter-claim and, therefore, I am compelled by the decisional law of this circuit to direct a verdict in favor of the plaintiff and against the defendant in the amount of seventeen thousand seven hundred thirty-four dollars and fifty-six cents, which is the amount of the deficit at the time of the liquidation of the account, together with interest at six percent from that date.

Mr. Clerk, will you hand that verdict to one of the jurors.

Supreme Court, U. S.
FILED
SEP 8 1975
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-218

DEAN D. BEKKEN, *Petitioner,*

v.

MERRILL LYNCH PIERCE FENNER & SMITH, INC., *Respondent.*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF IN OPPOSITION

Of Respondent, Merrill Lynch Pierce Fenner & Smith, Inc.

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IN THE

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OCTOBER TERM, 1975

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MERRILL LYNCH PIERCE FENNER & SMITH, INC., *Respondent.*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

---

BRIEF IN OPPOSITION

Of Respondent, Merrill Lynch Pierce Fenner & Smith, Inc.

STATEMENT OF THE CASE

Because there has been no reported opinion of this case by the District Court or the Court of Appeals, and because a directed verdict was given at the conclusion of the trial by the District Judge, Honorable

Seybourn H. Lynne, respondent will present the facts (and argument) in greater detail than it otherwise would in order that this Court may fully understand the issues.

(A) The Proceedings in the District Court

Petitioner in his answer to respondent's complaint denied all the material allegations thereof except those relating to jurisdiction and that he had entered the agreement between the parties, respondent's exhibit 1 (A. 32, 213); the District Court in its pre-trial order stated "defendant pleads the general issue", and as to petitioner's counterclaim, stated: "The defendant contends that it has a cause of action under Rule 431 because he was misled by Mr. Yarbro, plaintiff's agent" (A. 8).

(B) The Relevant Facts

Respondent would add to or modify the petitioner's statement of the case by the following facts, which are taken from the testimony upon the trial of this cause.

Petitioner, Dean Bekken, on the day he opened his account with respondent, purchased 500 shares of Kaufman & Broad (K & B) stock, paying cash for them; it was four or five months later before he purchased on margin (A. 30 & 31). Bekken made the initial decision to purchase K & B, and did not seek Yarbro's advice and did not even know if Yarbro was familiar with K & B (A. 194 & 195; 30).

Bekken had first traded on the stock market in 1949 (A. 167). His net worth when he opened his Merrill account in July, 1971, and as shown on respondent's exhibit 2 was $150,000 (A. 30, 214 & 170). During the period from March through May, 1973, Bekken was

teaching school from 8:00 a.m. to 3:30 p.m., so that Yarbro could not call him, but could only leave messages for him (A. 99; 154 & 155; 164).

Bekken had lost money in the stock market before dealing with Merrill Lynch, and he knew that a broker could not predict a stock's performance (A. 168). Bekken had withdrawn funds from other margin accounts he had had prior to his Merrill Lynch account (A. 192 & 193).

When Bekken withdrew funds from his account in 1972, a total of $59,400, Yarbro informed him of the interest rate (A. 34 & 35), and that such action might later precipitate maintenance calls (A. 111). On March 16, 1973, at the time Bekken received his first maintenance call, his debit balance was $74,464. respondent's exhibit 4, A. 38, 216). At the time the account was liquidated (May 18) the debit balance was $41,191., so that if Bekken had not borrowed this sum, there would not have been any liquidation. (Respondent's exhibit 4, A. 38 & 218).

Bekken was aware during the March - May, 1973, period of the New York Stock Exchange (N.Y.S.E.) maintenance margin requirement (25%) and its relationship to Merrill Lynch's requirement (30%):

> Q. At what point in time did you become acquainted that there was a maintenance margin requirement of the New York Stock Exchange in the amount of twenty-five percent?
>
> A. I don't believe that I was aware of the New York maintenance requirement of twenty-five percent until the period of time of March to May of 1973, or I was aware that there was a maintenance margin requirement prior to that by some brokerage house, which one I don't remember, although

I had never received a maintenance margin requirement until March 16, 1973 (A. 150).

Q. Had Mr. Yarbro discussed it with you, the New York Stock Exchange maintenance margin requirements?

A. There was some mention of the fact that the New York Stock Exchange did have a maintenance margin requirement but that Merrill Lynch's was in excess of that and, therefore, that was what I would be confronted with and that was what the maintenance calls which I received were based on (A. 151).

Bekken stated he was not misled as to how his margin maintenance calls were determined (A. 210). Bekken was aware throughout the period of March - May, 1973, that Merrill Lynch could sell the securities in his account, and that he likewise could sell them (A. 171); that market appreciation would lessen the likelihood of maintenance calls, or could eliminate calls; and was aware of what his indebtedness was to Merrill Lynch (A. 172); and, also, that sales reduced his debit balance (A. 173).

Bekken was also aware that Yarbro could be overruled by his superiors and the account liquidated under appropriate circumstances:

Q. So, you were aware under certain circumstances which were not present until the latter part of this transaction, till this week in May when you were closed out, but that under certain circumstances you were aware that Mr. Yarbro's directions to you could be reviewed and overruled by someone above him with Merrill Lynch, were you not, if the circumstances changed what he told you could be overruled?

A. Yes.

Q. And you were aware of that throughout this period if the circumstances changed and the account became in what you previously termed a precarious position?

A. That's correct (A. 177 & 178).

Bekken knew, as Yarbro told him on several occasions (A. 52, 118), that continued market depreciation would require cash payments or a sale of securities to meet maintenance calls (A. 186). Bekken did not consider as "nominal" the approximately $34,000. he paid Merrill from March 20, 1973, to May 16, 1973, on his account as a result of maintenance calls, and he felt he had shown "good faith" in his efforts to meet the calls (A. 179 & 180). In Yarbro's discussions with Bekken about the maintenance calls Yarbro stated he always told Bekken the same as to what he must do to meet them (A. 99), and consistently referred to "eliminate", "satisfy" or "meet" the call (A. 47, 51, 55, 62, 66, 69, 94 & 95).

Bekken's action in response to the first maintenance call for March 16, received on March 20, 1973, a sale of 100 shares of Franklin Mint Corporation, fully met the March 16 call (A. 174 & 175; 116 & 117). During the critical period in May, as a result of sale of stock, deposits of cash and market appreciation, there was no maintenance call for May 3, 1973, under either Merrill Lynch or N.Y.S.E. requirements, nor any call under N.Y.S.E. requirements for May 9 (A. 75, 78; plaintiff's exhibits 4 & 6; A. 38 & 216; 74 & 219).

Yarbro told Bekken on May 11, 1973, that because the negative article on K & B in Barron's that the stock and warrants would probably open lower on May 14 (Monday), and that "a larger call would be coming" (A. 61

& 62). When the stock (and warrants) were closed to trading on May 14, Yarbro told Bekken the price under the circumstances would be lower on May 15, "which would increase the maintenance call" (A. 63). Bekken related Yarbro explained what he learned as to why K & B was closed on May 14, and ". . . then confirmed the fact that it probably would open appreciably lower on Tuesday . . ." (A. 158), and that a large maintenance call would be coming (A. 197). Because of the market close on K & B, Bekken's account could not be sold out on May 14 (A. 117).

Bekken admitted that Yarbro told him on May 15 that the maintenance call for the close that day would be "appreciably larger" (A. 162). Bekken told Yarbro he was going to try to sell some bank stock or borrow some money to meet the call (A. 67 & 68), and Yarbro related this to Edwards, his office manager (A. 137). The account was not in a debit equity until the close of the market on May 15 (A. 117 & 118; petitioner's exhibit 4; A. 38 & 218).

On either May 15 or May 16 Bekken's wife called K & B corporate offices to get information on the situation:

> Q. But sometime after May the 14th and prior to May 17th did someone in your family call the offices of Kaufman & Broad and talk with them?
>
> A. Yes.
>
> Q. Who was that?
>
> A. My wife.
>
> Q. Did she communicate to you what she learned?
>
> A. Yes, she did.
>
> Q. Were you encouraged by what you learned?
>
> A. Yes, I was.

> Q. And this in part affected your position and decision that you wanted to maintain in your account the stocks and warrants you held in Kaufman & Broad, did it not?
>
> A. Yes (A. 198 & 199).

On May 16 Edwards, the office manager of Merrill Lynch, in the absence of Yarbro, called Bekken's home in the morning, and since Bekken was out, told Mrs. Bekken to have Mr. Bekken call; that " . . . it was extremely urgent that he get in touch with me as soon as possible" (A. 126). Edwards was in the office all day, but Bekken did not call (A. 127). Bekken said he learned of Edwards' call at 5:00 or 5:15 p.m. (A. 163). Although he went to the Merrill Lynch office thereafter, he did not find out the amount of his maintenance call for that day until May 17 (A. 197 & 198).

Bekken testified that he probably could not have met the call for May 15 even if he had met in full with cash the call for May 14 (A. 189 & 190); and that if he had met the call each day during the period May 14-17, the next day there would have been a new call because of the declining value of his securities (A. 191; plaintiff's exhibit 4; A. 38, 216-218).

Bekken admitted Merrill Lynch had not misled him as to performance of K & B or any information supplied on K & B (A. 169). Until May 18, 1973, when the account was liquidated, Yarbro had never sold any securities of Bekken's without his knowledge and consent and by his direction (A. 59). On May 18, Bekken did meet a maintenance call on another account with Merrill Lynch and preserve it (A. 73, 129).

Bekken never inquired of Yarbro whether there was a specific time within which he must meet a mainte-

nance call (A. 47). As to Bekken's position on whether Merrill Lynch imposed a reasonable time limit, Bekken testified:

> A. Well, I contend during the week of 14 to 18 May that that was a reasonable time. I'm not quite sure that I fully understand your question.
>
> Q. I'm not certain I understand your answer. Do you feel that the requirement that Merrill Lynch imposed on you to meet the margin maintenance calls during the week of May the 14th to the 17th was an unreasonable or a reasonable period of time?
>
> A. Reasonable (A. 183).

Bekken's contention as to how he was misled by Yarbro and Merrill Lynch was stated thus:

> Q. In substance, Colonel Bekken, am I correct that your contention as to how you may have been misled by Mr. Yarbro as to meeting margin maintenance calls is that he didn't set a specific time within which you had to fully meet a maintenance call?
>
> A. Well, that with the fact that I had to fully meet it.
>
> Q. All right, sir.
>
> A. Not only the time, but the amount.
>
> Q. And is it not true that he did tell you that if the market continued to decline on your stocks there would come a point in time when given the fact that you didn't have a market appreciation, you would have to meet a margin maintenance call by payment of cash or sale of the securities?
>
> A. Well, he did mention that if the account got in such a state that Merrill Lynch would liquidate it (A. 184 & 185).

Yarbro's judgment was that he did not have discretion to excuse Bekken from meeting maintenance calls

(A. 84); however, Merrill Lynch did interpret Rule 431 as giving the broker some discretion as to the time within which a customer would be required to meet a call (A. 86, 104 & 105, 140). In exercising this discretion Merrill Lynch considered the following factors: the customer, his financial condition and knowledge of the market; the history of his account; the size of his account; the size of the maintenance call; the surrounding situation; and the customer's desires (A. 104-106; 122 & 123).

Bekken throughout expressed his desire not to sell his K & B securities. Yarbro expressed it thusly:

> A. He wanted to keep the Kaufman & Broad if at all possible because he was a believer in the stock, it had done well for him before, so he wanted to maintain the stock if at all possible and not sell it. . . . (A. 51).

On May 8 Bekken expressed again his desire to maintain K & B (A. 58); and on May 15, after Yarbro said Bekken reported his wife's call to K & B's corporate offices, Bekken said he "... didn't want to sell it unless he absolutely had to" (A. 66). On May 17 Bekken "... expressed a desire to want to hold the stock because he felt sure it would bounce back. . . ." (A. 69). He maintained this position to the end, telling Edwards on May 17:

> A. He did not want his stock sold out. In fact, he said if he could have some time he would like to retain Kaufman & Broad. He was very, very much sold on the idea that Kaufman & Broad was the stock to own (A. 128).

Bekken confirmed his desire throughout was to keep the K & B securities (A. 160, 186, 199).

ARGUMENT

I. BEKKEN'S COUNTERCLAIM BASED ON VIOLATION OF RULE 431

(A) The Distinction Between "Maintenance" Margin and "Initial" Margin

Section 7 of the Securities Exchange Act of 1934, 15 U.S.C. § 78g, grants to the Federal Reserve Board the power to control the amount of credit which can be initially extended for the purpose of purchasing new securities. Accordingly, the Board of Governors has issued Regulation T (Reg. T), 12 C.F.R. § 220, which controls the amount of "initial" margin credit that brokers may extend to customers. The time allowed for the deposit of Reg. T margin ("settlement") is five days for general or margin accounts, such as Bekken's, with seven days being required for payment of securities in special or cash accounts. 12 C.F.R. §§ 220.3(b)(1), 220.4(c)(2). Because of its importance in comparison, it should be noted that Reg. T specifically commands the broker to liquidate securities in a customer's account if required funds or securities are not forthcoming within the time allowed. 12 C.F.R. § 220.3(e), § 220.4(c)(2).

Reg. T does not require that the initial margin be maintained after initial compliance, 12 C.F.R. § 220.7 (b). The N.Y.S.E., however, prescribes the margin that must be maintained in its Rule 431. For the type of account involved in this case, Rule 431 requires that the aggregate of all securities "long" in the account must be maintained at a 25% margin level, which is to say that the equity in the account must equal 25% of the current market value of the securities. Exchange members, such as petitioner, may set their own "maintenance" margin requirement for their customers,

provided it is higher than the Exchange's, and petitioner's requirement in the spring of 1973 was 30%, which was the basis of the maintenance margin calls issued in the Bekken account.

The only reference to the amount of time which is allowed for payment of maintenance margin is contained in one sentence in Rule 431 which provides that: "The amount of margin . . . required . . . shall be obtained as promptly as possible and in any event within a reasonable time." N.Y.S.E. Rule 431(d)(6). It is significant to note that this language tracks that of the time required for payment of initial margin in such accounts under Reg. T, 12 C.F.R. § 220.3(b)(1), with the one important difference of "within a reasonable time" instead of "before the expiration of 5 full business days."

(B) Is There Authority for Petitioner's Counterclaim?

Petitioner's basic contention is that Rule 431 has the force and effect of law in that it must be integrated into the omission of Reg. T to regulate maintenance margin, because Congress declared in the Securities Exchange Act of 1934, as a matter of public policy, its concern for the regulation of credit in the purchase and ownership of securities. Thus, petitioner contends that Rule 431 places a duty upon the broker to obey the rule for the benefit of the customer, and a violation impliedly creates a cause of action in favor of the customer. Respondent submits there is no authority for this contention under the facts of the instant case.

The springboard for petitioner's contention is the holding in *Pearlstein* v. *Scudder & German,* 429 F.2d 1136 (2d Cir. 1970), *cert. den.,* 401 U.S. 1013. Here

the court implied a federal civil cause of action in favor of the customer against his broker for violation of 12 C.F.R. 220.4 (C)(2) for not liquidating the customer's securities within seven days for nonpayment of the required initial margin.

Apparently Congress has legislatively removed the primary basis for this decision, as also has the Federal Reserve Board. In October, 1970, Congress amended Section 7 of the Securities Exchange Act of 1934 by adding subsection (f), 15 U.S.C. § 78g (f)(1), which states in pertinent part:

> It is unlawful for any United States person, . . . to obtain, receive, or enjoy the beneficial use of a loan or other extension of credit from any lender . . . for the purpose of (A) purchasing or carrying United States securities, or (B) purchasing or carrying within the United States any other securities, if, under this section or rules and regulations prescribed thereunder, the loan or other credit transaction is prohibited . . . .

The Federal Reserve Board then conformed its regulations to this new public policy expressed by Congress by issuance of Regulation X, 12 C.F.R. § 224.2, which in pertinent part states:

> A borrower shall not obtain for any purpose credit from within the United States unless he does so in compliance with the following conditions: . . . (2) Credit obtained from a broker/dealer shall conform to the provisions of Part 200 (Regulation T) which is hereby incorporated in this part (Regulation X).

The term "obtain credit" is defined by 12 C.F.R. § 224.1, as meaning to "obtain, receive or enjoy the beneficial use of credit."

These changes make it clear, respondent submits, that the Securities Exchange Act of 1934 and Reg. T were not intended and do not now place a duty upon the broker for the benefit of the customer to obtain the payment of initial margin. For now that it is unlawful as to the customer also, it is clear that it is equally his duty to pay. Presumably this should remove any implied cause of action in favor of the customer for mere noncompliance by the broker of Reg. T. Certainly it should remove any basis for the assertion that there can be an implied cause of action for violation of Rule 431 by implied relationship to Reg. T. Respondent has found no cases following the *Pearlstein* rule since this change in the law.

This change in the Federal scheme of regulation of initial credit also makes it more manifest that the purpose of Rule 431 is protection of the broker, not the customer. It should be clear that a rule that requires a debtor to provide a continuing minimum amount of security to his creditor is intended for the benefit of the creditor, especially where the creditor's association imposes the rule. If the purpose were otherwise, then the rule could have very simply so stated.

There are only three cases that respondent has found that have determined the customer has an implied cause of action for the broker's failure to follow an exchange or association rule. However, none deal with Rule 431 and all involve allegations of willful misconduct on the broker's part tantamount to or actually constituting fraud. *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir.), *cert. den.* 396 U.S. 838 (1969) (N.Y.S.E. Rule 405, "know your customer"); *SEC* v. *First Securities Company of Chicago,*

463 F.2d 981 (7th Cir.), *cert. den. sub. nom., McKy* v. *Hockfelder,* 409 U.S. 880 (1972) (NASD "supervision of representatives" rule); *Avern Trust* v. *Clarke,* 415 F.2d 1238 (7th Cir. 1969) (NASD "suitability" rule). Respondent emphasizes that the petitioner in his counter-claim avers that Merrill Lynch *negligently* violated Rule 431 (A. 6 & 7); there is no claim, obviously because there is a complete lack of any facts to support any, that Merrill committed fraud, was guilty of any fraudulent misconduct or any willful misconduct tantamount to fraud.

The agreement between the parties in the instant case provides that: "This agreement and its enforcement shall be governed by the laws of the State of New York" (Respondent's exhibit 1, A. 32, 213). New York decisions have uniformly and consistently rejected claims for damages by customers for violations of exchange rules on margin requirements. *Rubin* v. *Solomon*, 136 Misc. 527, 241 N.Y.S. 495 (1930); *Nichols & Co.* v. *Columbus Credit Corp.,* 204 Misc. 848, 126 N.Y.S. 2d 715, *aff'd per curiam,* 284 App. Div. 870, 134 N.Y.S. 2d 590 (1953); *Hirsch & Co.* v. *Pattiz,* 19 App. Div. 2d 607, 241 N.Y.S. 2d 124 (1963).

The Federal courts have also declined to imply a cause of action for damages in behalf of the customer for mere violations of broker association or exchange rules. *Colonial Realty Corp.* v. *Bache & Co.,* 358 F.2d 178 (2d Cir.), *cert. den.* 385 U.S. 817 (1966); *O'Neill* v. *Maytag,* 339 F.2d 764 (2d Cir. 1964); *Shemtob* v. *Shearson, Hammill & Co.,* 448 F.2d 442 (2d Cir. 1971); *Bowman* v. *Hartig,* 334 F.Supp. 1323 (S.D.N.Y. 1971); *Wells* v. *Blythe & Co., Inc.,* 351 F.Supp. 999 (N.D. Cal. 1972).

Respondent's position that petitioner has no basis for counterclaim (or a defense) was adopted in a case closely in point by the Court of Appeals of Michigan, *Goodbody & Company* v. *Penjaska,* 8 Mich. App. 64, 153 N.W.2d 665, *cert. den.* 393 U.S. 16 (1968). The plaintiff-broker sued to recover a deficiency after liquidation, and the defendant offered as a defense and counterclaim that the plaintiff had not complied with an unspecified N.Y.S.E. rule (apparently 431). The account had been undermargined from February 3, 1960, to March 8, 1960, before demand for additional margin was made, and it was not sold out until March 29, 1960. The court cited with approval the holding of the N.Y. court in *Nichols & Co.* v. *Columbus Credit Corp., supra,* and held the defendant had no defense and no counterclaim, finding for the plaintiff for the amount of the deficiency.

This brings us to a consideration of the Fifth Circuit Court of Appeals' two recent decisions in *Gordon* v. *duPont Glore Forgan, Inc.,* 487 F.2d 1260, *cert. den.* 94 S.Ct. 3071 (1974) and *McCormick* v. *Esposito,* 500 F.2d 620 (1974). In *Gordon* the court held that a customer who knew that his account was undermargined and did not complaint could not recover damages from the broker on either a common law claim of breach of duty or an implied cause of action arising out of violation of N.Y.S.E. Rule 431. This despite the negligence or error of the broker in computing and notifying of the margin required, and an undermargining that occurred for several months continuously. Respondent submits this holding clearly establishes the petitioner has no basis for a counterclaim in this case, for there is no dispute in the testimony that throughout and on an almost daily basis Bekken received verbal

and written notices of his margin position—and that he never complained in any way about Merrill Lynch's conduct. (Of course Merrill Lynch also insists that it was not negligent, nor violated any rules of the N.Y. S.E., nor breached any duty owed Bekken, to be fully treated hereinafter.)

The holding in *McCormick* is even more closely in point. There it was held that the customer did not have a cause of action against the broker for a violation of Rule 431. The report shows that for the period November 18-28, 1969, the account was undermargined. The report is unclear as to whether Goodbody had knowledge of this, or not, since the only statement in that regard it:

> Goodbody's failure to discover the undermargining of McCormick's account *or to require that McCormick provide additional margin* might be considered less excusable than the oversight involved in the *Gordon* case. (500 F.2d at 627, emphasis added)

Nor does the report state what occurred on November 28, 1969, or shortly thereafter, although presumably the undermargining ceased because the account was not liquidated until February, 1970. However, the court placed emphasis on two factors: (1) there was no evidence that Goodbody intentionally ignored Rule 431 or sought to mislead McCormick; and (2) McCormick knew or had reason to know of the undermargining and did not complain.

Respondent contends the facts in the instant case sustain the district court's finding that under *McCormick* petitioner has no basis for a counterclaim. First, *assuming arguendo* that Merrill Lynch

did violate Rule 431, for the purposes of considering the ruling of *McCormick* in light of the instant facts, it must be remembered that petitioner in his counterclaim has characterized respondent's conduct as *negligent* (A. 6 & 7). This is insufficient to constitute a claim for relief. Second, there is no evidence that Merrill intentionally violated Rule 431 to mislead Bekken, which is the requirement of McCormick (500 F.2d at 628). Third, the evidence is overwhelming that Bekken was fully informed throughout and never complained of any action or inaction on the part of Merrill. Thus, it can be seen why the Fifth Circuit Court of Appeals affirmed the district court's verdict without opinion.

II. BEKKEN'S DEFENSE BASED ON VIOLATION OF RULE 431

Respondent would at the outset recall to the Court's attention that Bekken in his answer did not present any defense based upon violation of Rule 431. Certainly such defense must be considered as ". . . matter constituting an avoidance or affirmative defense", which pursuant to Rule 8, F.R.C.P., must be set forth affirmatively. As previously noted, the district court in its pre-trial order does not set out any other defense to respondent's claim than "the general issue" (A. 8). If it may be said that petitioner's counterclaim was mistakenly so designated or otherwise should be considered as a defense, respondent urges again to the Court that Bekken claims therein that Merrill *negligently* violated Rule 431; and the district court in its pre-trial order stated that this claim depended upon Bekken's contention that "he was misled by Mr. Yarbro" (A. 8). This last claim of misleading conduct was an effort by the petitioner, and a recognition

by the district court, that for Bekken to be able to state a claim under the holding in *McCormick* v. *Esposito, supra,* there must be conduct misleading to the customer by the broker. Obviously, therefore, the counterclaim was intended as just that, and not as a defense. There is no dispute, and no issue drawn by petitioner, that respondent proved all the material allegations of its complaint. Therefore, respondent submits that this reason alone is sufficient to sustain the courts' decision as to petitioner's claimed defense. However, respondent will go forward to show there is no merit to that defense.

(A) Is There Authority that Violation of Rule 431 Is a Defense to Merrill's Claim?

As mentioned before, the agreement between the parties provides that it is to be governed by New York law. The New York decisions have not allowed a violation of exchange rules requiring the broker to obtain maintenance margin to be a defense to the broker's claim for a debit balance after liquidation. *Hirsch & Co.* v. *Pattiz, supra; Whyte* v. *New York Mercantile Exchange,* 36 Misc.2d 745, 233 N.Y.S.2d 37 (1962).

The ruling of the court in *Goodbody & Company* v. *Penjaska, supra,* clearly holds that failure of the broker to obtain the maintenance margin required by the N.Y.S.E. (apparently Rule 431) for a period of almost two full months is no defense to the broker's action for a deficiency upon liquidation of the customer's account. There the court said:

> "Admittedly, they were in the office of plaintiff almost every day, and admittedly they were familiar with the market. At no time did they demand that their stock be sold. Certainly they had as great a duty to protect their account as did the plaintiff. They did not complain because the plaintiff was lenient. I doubt if complaint would have been made had the price of the stock advanced during the period of leniency" (153 N.W.2d at 667).

This statement fits perfectly the facts of the instant case.

The holding in *Gordon* v. *duPont Glore Forgan, Inc., supra,* does not provide an answer to this question. In *Gordon* the court did determine that the misconduct of the broker disallowed its recovery of a debit balance, but this decision obviously was not based upon violation of the N.Y.S.E. rule, but rather breach of the common law or contractual duty arising out of the broker-customer relationship. Judge Thornberry said:

> "While it is true that the Gordons had a contractual obligation to make up the $1550. deficit, it is also true that the deficit was at least partially the result of duPont's failure to compute the margin status correctly and give prompt notice of the undermargining. We cannot allow duPont to recover indebtedness that resulted from its own breach of duty, and therefore we must reject its counterclaim" (487 F.2d at 1262).

In the instant case the determinative facts or errors on the part of duPont in *Gordon* are not present, as Merrill Lynch did compute Bekken's margin status correctly and did give prompt notice of his undermargined condition.

McCormick is silent as to whether violation of Rule 431 may be a defense, since no claim was presented there by the broker against the customer. It would

appear, however, that under the rule of *McCormick,* namely an "intentional violation of Exchange rules misleading of its customer", such conduct by the broker would constitute a defense to a broker's claim for a deficit. However, that is not present in this case for: (1) as to petitioner's counterclaim, if it may serve as a defense, he claims "negligently"; (2) there is no proof Merrill "intentionally" violated Rule 431; and (3) petitioner was not misled. The evidence in these regards, as set out in the Statement of the Case, will be reviewed shortly hereinafter.

(B) The Meaning of Rule 431

Rule 431(b)(1) prescribes the amount of margin which must be maintained in a customer's account as 25%, and Rule 431(d)(6) provides: "The amount of margin . . . required by any provision of this Rule shall be obtained as promptly as possible and in any event within a reasonable time." There is no dispute that during portions of the period in question Bekken's account was undermargined. However, Merrill rejects the implication of Bekken's argument that in effect undermargining for *any* length of time constitutes a violation of the rule. The practical impossibilities of this argument when applied to the full scope of stock margin accounts in this country clearly demonstrates its fallacy. To petitioner "as promptly as possible" means literally that—and without exception or consideration of any circumstances; therefore, in every customer's account on margin, when for whatever reason the equity in the account fell below 25% of the market value, the broker would be required to sell securities at the first opportunity to restore the margin, provided the customer did not immediately provide the

requirement. Since the margin status is computed daily, this would mean at the opening of the market the following day. This would also mean there would be odd lot sales by the thousands, for numerous daily margin calls would occur for very nominal sums, which would not require a liquidation of the account to meet. Furthermore, petitioner's unrealistic interpretation of "as promptly as possible" would in the vast majority of cases mean that the customer might never even have notice of the call, for the broker would be required to act immediately upon learning of the undermargining. Surely this Court can see the havoc such an interpretation would wreak upon the stock brokerage business, and would by no means be in the best interest of the customer. Clearly the Fifth Circuit Court of Appeals recognized the fallacy of this claim of petitioner.

Petitioner in his argument for implied liability for breach of Rule 431 under his counterclaim seeks to read Rule 431 into Reg. T; however, in interpretation of Rule 431 he is unwilling to recognize the analogy between the two. The Reg. T requirement for deposit of initial margin is ". . . as promptly as possible and in any event before the expiration of 5 full business days. . . ." (12 C.F.R. § 220.3(b)(1)). Rule 431 employs the same language only substituting "within a reasonable time" for the 5 day limitation. Under petitioner's reasoning and argument the modifying phrase in Reg. T should be totally disregarded and the prescription of the regulation merely be "as promptly as possible". However, the regulation is uniformly interpreted as giving 5 days to meet the requirement.

The only judicial interpretation of time limitation requirements for deposit of margin that respondent

has found, and petitioner has cited none, is a case dealing with sale of securities in a special cash account as governed by Reg. T. In *Naftalin & Co.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 469 F.2d 1166 (8th Cir. 1972), a customer sold securities which he purported to own but in fact did not. In such situations Reg. T requires that ". . . the security is to be promptly deposited in the account" (12 C.F.R. § 220.4(c)(1)(ii)). The court rejected the holding of the district court that "promptly" was the equivalent of the seven-day period set forth in § 4(c)(2) (12 C.F.R. § 220.4(c)(2)) for special cash account purchase transactions. In its reasoning the court notes that there is no mandatory requirement for liquidation of sales transactions in such accounts if securities are not delivered within any specified period (just as there is no such provision under N.Y.S.E. rules if maintenance margin is not deposited). Thus, this decision finds that "promptly" may be a period longer than seven days and is a term allowing for flexibility.

Respondent contends that the prescription of Rule 431 that margin shall be obtained as promptly as possible and in any event within a reasonable time is a rule of flexibility; that it allows discretion to the broker to view the customer, his account, the market and all the surrounding circumstances to determine the time limitation to be imposed, which in the final analysis is to be "reasonable".

(C) Does the Evidence Sustain the Lower Courts' Decisions?

The test of the evidentiary requirement for granting a directed verdict has recently been stated as follows:

> "Simply stated, it is whether the evidence is such that, without weighing the credibility of the witnesses or otherwise considering the weight of the evidence, there can be but one conclusion as to the verdict that reasonable men could have reached."

Simblest v. *Maynard*, 427 F.2d 1, 4 (2d Cir. 1970).

Respondent will not undertake to review the evidence at length, relying largerly upon the facts previously stated in the Statement of the case. The pertinent considerations are whether there was any sufficient evidence for the jury to conclude that: (1) Merrill Lynch intentionally or negligently violated Rule 431; and (2) Merrill Lynch misled Bekken in any way.

Respondent submits that the facts do not show any violation of Rule 431 by Merrill. Was it unreasonable not to liquidate Bekken's account until he had been on call only 6 days under N.Y.S.E. requirements? Respondent's answer is no; not when you have a customer who has been trading on the market 24 years with seven other brokerage firms; who has net worth of approximately $150,000., and the amount of the margin call is only 10 to 15 percent of that; not when he has shown good faith in answering earlier calls, which were eliminated, and over the last two months he has reduced his indebtedness in excess of $33,000.; not when he is fully aware of all the circumstances of which Merrill was aware, and had investigated independently the unusual circumstances surrounding his principal security, and he still expressed the desire to keep these securities and that they not be sold. And especially not when Bekken himself stated he felt Merrill's requirement to meet the calls during the week of May 14-17 was reasonable (A. 183).

Under the testimony the only claim of any misleading conduct on the part of Merrill was the failure to explic-

itly tell Bekken of the existence of Rule 431 and its requirement that margin shall be obtained "as promptly as possible and in any event within a reasonable time". Merrill submits this was not misleading on its part; that the record is wholly-devoid of any evidence that this nondisclosure was intentional or negligent; that to the contrary the record is replete with evidence that Merrill in fact did convey in substance its understanding and interpretation of the rule to Bekken. Surely a broker is not required to explain all the rules governing his customer's account to the customer, especially when the customer does not ask. Where then is the evidence he was misled? There was none, as the lower courts correctly concluded.

Under the holdings in *Gordon* and *McCormick* respondent submits there was no evidence of any intentional violation of Rule 431 misleading to Bekken in view of all the facts. Certainly at the very least Bekken acquiesced in, and respondent submits the evidence clearly establishes he actively requested Merrill's forbearance to obtain the required margin for the brief periods that it did. And respondent submits that a contributing proximate cause of the relevant margin maintenance calls was the act of the petitioner himself in making the withdrawals he had made during the prior year, which constituted the vast majority of his indebtedness, which also must nullify his claimed defense.

CONCLUSION

Petitioner has not demonstrated any reason under Rule 19, Supreme Court Rules, why this Court should grant certiorari. There are no decisions of any other circuit court of appeals in conflict with the decision in the instant case. This case does not involve an important question of Federal law. This decision by the Fifth Circuit Court of Appeals is not in conflict with other decisions of that court. Under the law and facts the petitioner has not demonstrated any error by the Fifth Circuit Court of Appeals in its decision affirming the district court's directed verdict. Respondent submits that under the facts of the instant case there has been no error in the lower courts, and that a writ of certiorari should not issue.

Respectfully submitted,

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Certificate of Service

I certify that copies of the foregoing Brief for Respondent have been served on opposing counsel by mailing copies by United States mail, postage prepaid, to Honorable Roscoe Roberts, P. O. Box 287, Huntsville, Alabama 35804.

This the 8th day of September, 1975.

Counsel for Respondent